IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,
vs.
RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

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Opinions Below

The opinion of the United States District Court for the Western District of New York is reported in 197 Fed. Supp. 441. The opinion of the United States Court of Appeals for the Second Circuit is reported in 298 Fed. 2nd, 655. The opinion of the referee in bankruptcy was published in Volume 35, No. 3 of the Journal of the National Association of Referees in Bankruptcy.

Jurisdiction

The jurisdiction of this court is invoked because this is a matter involving a bankrupt corporation and its creditors and the decision herein of the United States Court of Appeals for the Second Circuit is in conflict with the applicable decisions of the United States Court of Appeals for the Ninth Circuit and the United States Court of Appeals for the Tenth Circuit. The United States Court of Appeals for the Second Circuit has further decided a federal question in a way which is in conflict with the applicable decision of this court. The petition for a writ of certiorari was filed on March 5, 1962, and granted on April 16, 1962.

Statute Involved

This case involves the Miller Act, 40 U. S. C. A., Secs. 270A-270D. (Set forth in appendix.)

Question Presented

The question presented for review is whether the Reliance Insurance Company, which paid certain laborers and materialmen for services and materials furnished to the Dutcher Construction Corporation prior to that corporation's bankruptcy, is entitled to be paid prior to general creditors of the bankrupt Dutcher Construction Corporation, the monies earned by Dutcher Construction Corporation prior to its bankruptcy and paid over by the United States of America subsequent to said bankruptcy, to the Trustee in Bankruptcy, of Dutcher Construction Corporation.

Statement of Facts

The facts material to a consideration of the question presented are as follows:

The bankrupt, Dutcher Construction Corporation, executed a contract with the United States Corps of Engineers for certain construction on the St. Lawrence Seaway and furnished to the Corps payment and performance bonds; both issued by the Fire Association of Philadelphia, now named the Reliance Insurance Company. This was done on or about April 11, 1955, and was pursuant to the Miller Act, 40 U. S. C. A., Secs. 270A-270D.

The bankrupt entered into performance of its contract with the Corps of Engineers and incurred bills for labor and materials which were covered by the payment bond issued by the surety company. The bankrupt never defaulted in the performance of the contract so far as the Corps of Engineers was concerned, but the contract between the bankrupt and the Corps was terminated on April 11, 1956, for the convenience of the Corps and with the consent of the bankrupt.

When the contract was terminated, the bankrupt had completed a very substantial part of the contract but it had run out of money and left approximately $326,248.42 of unpaid bills covered by the payment bond. These the surety proceeded to pay pursuant to the terms of the payment bond. The surety further claims that it has expenses in connection with said payments of $20,754.34 and other payments of $22,924.99. The bills were paid by the surety in the spring and summer of 1956, and at the end of August, 1956, Dutcher Construction Corporation was adjudicated a bankrupt.

Subsequent to the termination of the contract with the Corps of Engineers; the Corps, with the consent of the bankrupt corporation, awarded the unfinished portion of the Dutcher contract to a joint venture of several corporations which agreed with the United States Corps of Engineers to complete the same at the Dutcher Construction Corporation prime contract price.

The joint venturers also agreed that they would do certain of the work which had been left unfinished by the bankrupt corporation for the sum of $40,000.00; said $40,000.00 to be a charge against the sum of $127,737.35 earned by the bankrupt and retained by the Corps of Engineers at the time of the termination of the bankrupt's contract.

Neither the Trustee nor the surety objected to this sum being taken from the Dutcher prime contract monies and, in fact, they agreed that this was a fair price to pay the joint venturers for the completion of the contract which should have been done by the bankrupt corporation. The joint venturers did complete their work and were paid $40,000.00, leaving a balance retained by the United States in the sum of $87,737.35. This sum was thereafter paid to the Trustee.

It is this sum of $87,737.35 to which the surety company asserts it has a right which is prior to the rights of the general creditors of the bankrupt corporation.

Summary of Argument

The Trustee in Bankruptcy's opposition to the application of the surety company is based on the fact that the surety company has paid materialmen and laborers who can assert no lien or priority against the funds in the

possession of the United States to the detriment of the general unsecured creditors. Consequently the surety company cannot by subrogation to the rights of the laborers and materialmen become entitled to assert a lien or priority against the same funds.

The Trustee further argues that there is a logical distinction between a surety company which has performed and thereby created a fund due from the United States for such performance and a surety which has paid laborers and materialmen and has not thereby created a fund due from the federal government. In the former case the creator of the fund should be rewarded for its efforts. In the latter case no reward is merited.

Argument

The petitioner relies principally on the following three cases:

1. *United States v. Munsey Trust Co.*, (1947), 332 U. S. 234, 91 L. Ed. 2022.
2. *American Surety Co. v. Oscar Hinds, Trustee* (C. A. 10), 1958, 260 Fed. 2d. 366.
3. *Phoenix Indemnity Co. v. Hugh A. Earle* (C. A. 9), 1955, 218, Fed. 2d. 645.

The petitioner-Trustee in Bankruptcy takes the position that the Reliance Insurance Company, which paid materialmen and laborers under its payment bond but which did not complete the bankrupt's job with the Corps of Engineers, is not entitled to a priority against the funds earned by the bankrupt prior to its bankruptcy and retained by the Corps of Engineers and subsequently paid over to the Trustee in bankruptcy.

The respondent Reliance Insurance Company, however, takes the position that it is entitled to the funds in question prior to the general creditors of the bankrupt whether it paid laborers and materialmen of the bankrupt pursuant to its payment bond or performed under the performance bond.

Basically, therefore, the Trustee claims there is no right of priority to the fund on the part of the Reliance Insurance Company because of payment under its payment bond. The Trustee concedes that there might be such a right of priority if the insurance company had performed under its performance bond thereby creating the fund retained by the federal government.

In the *Munsey* case, *supra*, a surety had written bonds for a government contractor on several jobs. These jobs were completed although the contractor left a number of laborers and materialmen unpaid. The surety paid these laborers and materialmen.

This same contractor had another contract with the federal government but no bonds had been furnished to the government by the contractor on this job which was not performed by the contractor. The government perforce secured another contractor to do the job but at a higher cost. Accordingly, the government was damaged to the extent of the increased cost of the unbonded job.

This court permitted the federal government to set off against the unpaid contract balances on the bonded jobs, *i.e.* the retainages, the excess cost to the government on the unbonded job.

This was a new problem for this court for, as Justice Jackson said at page 236:

"This case presents a problem arising out of contracts for public building construction and repair. The rights *inter sese* of contractor, surety, assignees and government have been productive of much litigation, but we have not heretofore had to decide whether percentages retained pursuant to contract by the United States may be subjected to its set-off claims despite the claims of a surety who has paid laborers and materialmen."

Consequently, the petitioner's position here is that we need look only so far as the *Munsey* case and the later opinions interpreting the *Munsey* decision.

That decision goes right to the problem here when Justice Jackson wrote, at page 240:

"But the surety urges that it is subrogated also to the rights of laborers and materialmen whom it paid and of the United States. From Prairie State Nat. Bank v. United States, 164 U. S. 227, 41 L. ed. 412, 17 S. Ct. 142, to American Surety Co. v. Sampsell, 327 U. S. 269, 90 L. ed. 663, 66 S. Ct. 571, we have recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert. Respondent tells us that here the United States is in the same position and that as a general creditor, it has no more right to the money which it holds than does any other general creditor of the contractor."

However, with this full awareness of the surety's position this court held against it, stating at page 242 that:

"In relying on the rights of the laborers and materialmen, however, the surety must establish that those rights existed before their claims were paid. For it is elementary that one cannot acquire by subrogation what another whose rights he claims, did not have. Once the laborers and materialmen have been paid, either by contractor or surety, they have

no rights in any fund. If before they are paid, the fund to which they are said to be entitled to look is unavailable for the very reason that they are unpaid, the surety relies on nothing when it relies on those non-existent 'rights'."

It would seem futile to refer to all the cases cited by the surety company in its briefs below. However, two of them were given great emphasis and will be briefly referred to.

In the brief and argument submitted to the United States Court of Appeals, Second Circuit, the respondent made much of the case of *Henningson v. U. S. F. & G. Co.* (1908), 208 U. S. 404, 28 Sup. Ct. 389. Respondent referred to the fact that this case was not mentioned in the *Munsey* case opinion and therefore reasoned that the principle of the *Munsey* case should be confined to its own facts, *i.e.* where the government was a party. The *Henningson* case, however, was cited to the court in the brief of the surety upon argument of the *Munsey* case.

Moreover, the *Henningson* case is far afield. It involved a contest between a surety who had paid under a payment bond and an assignee bank to whom the contractor had assigned his rights to the contract moneys in return for a loan of money to be used by the contractor on the job or not, as he saw fit.

The court distinguished the positions of the surety and the bank. The former became subrogated, it said, because it paid pursuant to contract; the bank, it was said, was a mere volunteer.

This is not our situation. The Trustee here represents all creditors. Some of them became creditors before the federal contract was executed and performance and payment bonds were issued.

Moreover, the surety can adjust its premiums. It is engaged in risk taking and was paid a large premium. The creditors cannot do this.

The surety has also given its approval to *Prairie State National Bank v. U. S.*, 164 U. S. 227 (1896). So has the petitioner for it is a performance bond case. There a contractor's surety *completed* the contractor's job and prevailed over a bank which was an assignee of the contractor. The *Prairie State* case was cited to this court in the *Munsey* briefs and mentioned in the *Munsey* opinion.

The cases which have followed and interpreted the *Munsey* case completely support the petitioner.

The *Hinds* case, *supra*, is on all fours with this one. Judge Medina at the time of the argument in the Circuit Court stated that if this case i.e. the *Hinds* case, is correct, the petitioner here must prevail.

In the *Hinds* case, the surety company on a payment bond furnished to the United States by the Bankrupt, as required under the Miller Act, sought an order requiring the Trustee in Bankruptcy to turn over to it monies received by the Trustee from the United States for work done by the Bankrupt and the Trustee who had completed the contract in question. The application was denied by the lower court and the United States Circuit Court of Appeals, 10th Circuit, affirmed the denial.

The court held that the surety, merely by reason of the payment of labor and material bills incurred by a contractor prior to its adjudication as a bankrupt and in accordance with its own obligation under its payment bond, did not acquire any right to net contract funds superior to the right of the Trustee representing the general creditors.

The court said, at page 368 of the opinion,

"The rights of a surety are largely derivative in nature. Having paid the laborers and materialmen, appellant may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States (*U. S. v. Munsey Trust Co.*, 332 U. S., page 241), the surety can rise no higher than the basis of the subrogation. The very purpose of the payment bond required under the Miller Act, is to shift the ultimate risk of non-payment from the workmen and the suppliers to the surety."

The court in the *Hinds* case also said, at footnote 5, on page 368:

"We are not required to consider whether a different rule might be applicable were a claim made under a performance bond."

The court did note a number of cases which would be favorable to the position of the surety company here and stated the facts of those cases were indistinguishable in substance from the facts of the *Hinds* case. Nevertheless, the court stated, again at page 368:

"We are not convinced, however, of the merit of reasoning which limits the clear holding of *Munsey* to factual situations where the government is a direct claimant. Mr. Justice Jackson, speaking for the court, notes that the claim of the surety must fail for *two* reasons, both the strength of the government's right to set-off and the weakness of the surety's claim to equitable rights in the fund. The reasoning of the opinion in the latter regard is in no way dependent upon the United States being a claimant."

The court also went on to say, at page 368:

"The very purpose of the payment bond required under the Miller Act is to shift the ultimate risk of nonpayment from workmen and suppliers to the surety. The United States does not retain funds for that purpose for it is said:

'But although we have assumed, for the purposes of another argument, that assurance that laborers and materialmen will be paid is one of the reasons for retaining the money, it seems more likely that completion of the work on time is the only motive. (Citations) It is hardly reasonable to withhold money in order to assure payments which perhaps can be made only from the money earned. In any event, we are not prepared to apply law relating to security to unappropriated sums which exist only as a claim.' *United States v. Munsey Trust Co.*, 332 U. S., at page 243, 67 S. Ct. at page 1603."

The appellant also relies on *Phoenix Indemnity Co. v. Earle, supra.* This case was decided in the Ninth Circuit eight years after the *Munsey* case.

In that case a contractor went bankrupt. The United States had asserted certain tax liens against the assets of the bankrupt in the hands of the trustee. The referee in bankruptcy held that the funds received by the trustee from the Bonneville Power Administration came into the hands of the trustee impressed with the tax liens and that the sum of the liens should be paid to the Director of Internal Revenue. The surety company appealed and the District Court affirmed. The surety again appealed to the Circuit Court.

The basic question was whether the government tax liens asserted against the funds in the hands of the trustee in bankruptcy were superior to the claim of the surety company.

The surety company had complied with the Miller Act, furnishing both payment and performance bonds.

The contractor did not default in performance. (Neither did Dutcher Construction Corporation default in its contract with the Corps of Engineers). However, the surety

company did pay materialmen and laborers pursuant to its payment bond.

The surety company asserted a right to the funds held by the trustee on the basis of subrogation. However, the court said at page 648:

> "In its brief the appellant based its right of subrogation upon its payments to labor and materialmen. In oral argument appellant expressly abandoned any claim of subrogation based upon materialmen's claims and appears to have no further claim of subrogation other than a passing remark in oral argument, that although it abandoned its rights to be subrogated to materialmen it did not give up any right to be subrogated to the rights of the Government. No prior nor further reference was made to such a right of subrogation to the Government's position, nor was any explanation or authority offered for such a claim during oral argument or in the brief.
>
> (1, 2) Such an assertion would seem to have been laid to rest in *United States v. Munsey Trust Co., supra*, from which the Referee quoted extensively in his 'Discussion of Law' in 'Referee's Findings, Opinion and Order' which were adopted in their entirety by the district court. After Justice Jackson established in the Munsey case that the United States was a secured creditor he said at page 241 of 332 U. S., at page 1602 of 67 S. Ct.:
>
> > 'But the infirmity in respondent's case goes deeper. If the United States were obligated to pay laborers and materialmen unpaid by a contractor, the surety who discharged that obligation could claim subrogation. But nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation. (Citations.) They cannot acquire a lien on public buildings, (citations) and as a substitute for that more customary protection, the various statutes were passed which require that a surety guarantee their payment. Of these, the last and the one now in force is the Miller Act [40 U. S. C. A. §270a *et seq.*] under which the bonds here were drawn.'"

Consequently, the appellant's position is sustained completely by these two authorities which the Second Circuit Court has chosen not to follow. Indeed, the Second Circuit seemingly had some doubt on its own position and the meaning of the *Munsey* case for after stating that the *Hinds* and *Phoenix* cases had miscontrued the *Munsey* case, the opinion stated at page 658:

> "If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say they held the point open for decision in the future."

But can it be said that this court has left the point open? Certainly the Ninth and Tenth Circuit Courts have not, as the Second Circuit Court readily admits. Those circuit courts had no doubt that the question was decided in the *Munsey* decision.

Moreover, in *Massachusetts Bonding & Insurance Co. v. State of New York* (1958) 259 Fed. 33, the United States Court of Appeals for the Second Circuit had to consider the conflicting rights of a surety, a bankrupt corporation and the United States. This case was also a Miller Act case and the surety contended that it was entitled to be subrogated to the position of the United States in relation to the latter's liens for taxes with interest and penalties which were satisfied prior to bankruptcy by set-off against money earned by the bankrupt on a job for the United States. The Second Circuit Court said at page 36:

> "But the surety cannot establish this fact, for under the doctrine of *United States v. Munsey Trust Co.* * * *, neither the bankrupt nor the surety ever became entitled to those funds, so that there was nothing for the surety to own. In short, the surety by way of subrogation might be entitled to progress payments and retained percentage, due its principal *if the surety completes the job after the principal's default.* (Citing numerous authorities)."

Consequently, we contend that the holding in the instant case is not even in accord with the previous decision of the United States Court of Appeals for the Second Circuit in *Massachusetts Bonding & Insurance Co., supra.*

However, if we are to return to basic reasoning rather than a citation of authority, what will be the decision of the court in the following assumed situation.

> A trustee in bankruptcy receives funds from the federal government for work done by the trustee on public construction, which funds were retained by the government during the course of the trustee's construction. Assume further that the bankrupt and its trustee never defaulted in performance. Assume, however, that the surety company on a payment bond furnished pursuant to the Miller Act paid materialmen and laborers for work done for the bankrupt prior to bankruptcy.

This is the situation presently before the District Court for the Northern District of Texas on appeal from a decision of the Referee in Bankruptcy of that court. That Referee in Bankruptcy was aware of the history of this case up to and through the decision of the Second Circuit Court. In fact, the *Hinds*, *Phoenix* and *Dutcher* cases were cited to him. That Referee held, and logically we believe, that the surety could not assert a priority to the retainages over the general creditors of the bankrupt. That Referee saw the need of distinction between the surety who had performed and created a fund and a surety who has merely paid.

If that Referee had held otherwise, the Trustee who did the work would not have received the funds and the surety who did not do the work would have received the funds.

The only solution here is obviously a holding that he who performs, secures the fund. The surety here has not performed. It is engaged in risk business. It was paid handsomely for the risk and now should take its place with the general creditors.

CONCLUSION

For the reasons stated it is respectfully submitted that the order and judgment of the United States Court of Appeals for the Second Circuit should be reversed and the order of the Referee in Bankruptcy of June 9, 1961, be reinstated.

RAYMOND T. MILES,
Counsel for Petitioner.

July 24, 1962.

Appendix

§ 270a. Bonds of contractors for public buildings or works; waiver of bonds covering contract performed in foreign country.

(a) Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as "contractor":

(1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as he shall deem adequate, for the protection of the United States.

(2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person. Whenever the total amount payable by the terms of the contract shall be not more than $1,000,000 the said payment bond shall be in a sum of one-half the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $1,000,000 and not more than $5,000,000, the said payment bond shall be in a sum of 40 percentum of the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $5,000,000 the said payment bond shall be in the sum of $2,500,000.

(b) The contracting officer in respect of any contract is authorized to waive the requirement of a performance bond and payment bond for so much of the work under such contract as is to be performed in a foreign country if he finds that it is impracticable for the contractor to furnish such bonds.

(c) Nothing in this section shall be construed to limit the authority of any contracting officer to require a performance bond or other security in addition to those, or in cases other than the cases specified in subsection (a) of this section. Aug. 24, 1935, c. 642, § 1, 49 Stat. 793.

§ 270b. Same; rights of persons furnishing labor or material.

(a) Every person who has furnished labor or material in the prosecution of the work provided for in such contract, in respect of which a payment bond is furnished under section 270a of this title and who has not been paid in full therefor before the expiration of a period of ninety days after the day on which the last of the labor was done or performed by him or material was furnished or supplied by him for which such claim is made, shall have the right to sue on such payment bond for the amount, or the balance thereof, unpaid at the time of institution of such suit and to prosecute said action to final execution and judgment for the sum or sums justly due him: *Provided, however,* That any person having direct contractual relationship with a subcontractor but no contractual relationship express or implied with the contractor furnishing said payment bond shall have a right of action upon the said payment bond upon giving written notice to said contractor within ninety days from the date on which such person did or performed the last of the labor or furnished

or supplied the last of the material for which such claim is made, stating with substantial accuracy the amount claimed and the name of the party to whom the material was furnished or supplied or for whom the labor was done or performed. Such notice shall be served by mailing the same by registered mail, postage prepaid, in an envelope addressed to the contractor at any place he maintains an office or conducts his business, or his residence, or in any manner in which the United States marshal of the district in which the public improvement is situated is authorized by law to serve summons.

(b) Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing, in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere, irrespective of the amount in controversy in such suit, but no such suit shall be commenced after the expiration of one year after the day on which the last of the labor was performed or material was supplied by him. The United States shall not be liable for the payment of any costs or expenses of any such suit. As amended Aug. 4, 1959, Pub. L. 86-135, § 1, 73 Stat. 279.

§ 270c. Same; right of person furnishing labor or material to copy of bond.

The Comptroller General is authorized and directed to furnish, to any person making application therefor who submits an affidavit that he has supplied labor or materials for such work and payment therefor has not been made or that he is being sued on any such bond, a certified copy of such bond and the contract for which it was given, which copy shall be *prima facie* evidence of the contents, execution, and delivery of the original. Applicants shall

pay for such certified copies such fees as the Comptroller General fixes to cover the cost of preparation thereof. As amended Aug. 4, 1959, Pub. L. 86-135, § 2, 73 Stat. 279.

§270d. Same; definition of "person" in sections 270a, 270b and 270c.

The term "person" and the masculine pronoun as used in sections 270a-270c of this title shall include all persons whether individuals, associations, copartnerships, or corporations. Aug. 24, 1935, 642, § 4, 49 Stat. 794.